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United States Senate

COMMITTEE ON SMALL BUSINESS & ENTREPRENEURSHIP
WASHINGTON, DC 20510-6350

July 25, 2002

BY FACSIMILE
ORIGINAL BY U.S. MAIL

The Honorable Charles O. Rossotti
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Mr. Joseph Kehoe
Commissioner
Small Business/Self-Employed Division
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Dear Commissioners Rossotti and Kehoe:

Thank you for providing a briefing on the Internal Revenue Service's (IRS) Schedule K-1 compliance initiative, which the agency recently initiated. Your staff was most helpful in addressing many of my concerns and receptive to suggestions offered by my staff. In addition, I was pleased to learn of the steps you are taking to evaluate the effectiveness of this program at an early stage with an eye toward making necessary modifications.

At the outset, let me reiterate my strong support for the IRS' efforts to use computer matching as an efficient means of identifying taxpayers who fail to comply with their obligations under the tax laws. If done properly, I believe that matching the millions of Schedule K-1s that the IRS received each year to taxpayers' individual tax returns can help identify significant amounts of under-reported income and serve as an incentive for better compliance by taxpayers receiving such schedules.

My general support notwithstanding, the Schedule K-1 matching initiative raises several troubling issues. The first is the agency's inability to match all the information on a Schedule K-1 to the tax return that individuals are currently required to file. As I understand the initiative, the IRS is attempting to match Schedule K-1 information to previously filed returns, which were not designed to reflect such information directly in most cases. In addition, taxpayers were not required to submit with those returns information to reconcile differences between a Schedule K-1 and their tax return.

For example, a net loss reported on a Schedule K-1 may be only partially reported (if at all) on a taxpayer's Form 1040 because the at-risk rules or basis adjustments may limit the amount of such losses that can be deducted. Similarly, net income may also be reduced by passive-activity losses that were suspended in prior years, again changing the information that is ultimately reported on the taxpayer's return from that stated on the Schedule K-1. Accordingly, a pure computer-based matching effort will lead to erroneous results in many instances and unnecessary notices to taxpayers.

Your effort to stem the number of unnecessary notices by having examiners manually screen returns is a welcome precaution. I am concerned, however, that these employees are trying to determine if a taxpayer is under-reporting income based on information that may not be available in the return and, in many cases, that the taxpayer was never required to report to the IRS (e.g., suspended passive-activity losses, basis adjustments, at-risk limitations). As a result, there is a significant potential that taxpayers will receive notices that a mismatch has been identified and then have to spend valuable time and scarce cash resources on accountants and tax preparers to justify that their return was correctly filed.

This burden is likely to have a heavy cost for small business owners. Accordingly, once the initial evaluation of the program is completed, I would appreciate your providing me with the following information: (1) the total number of Schedule K-1s matched; (2) the total number of notices sent to taxpayers resulting from the match; (3) the total dollar amount of proposed adjustments included in the notices; (4) the number of notices that resulted in no change to the taxpayer's account; (5) the total dollar amount of additional tax collected due to the notices; and (6) how much of the additional tax relates to cases in which the taxpayer failed to report the Schedule K-1 at all.

If the Schedule K-1 matching initiative is continued, I urge you to help taxpayers report the information from the Schedule K-1 in a manner that will allow them to avoid a matching-error notice in the future. Ideally, this should be accomplished by modifying Form 1040 so that taxpayers can directly report the information from the Schedule K-1 and indicate when such information has been modified due to a particular provision of the law (e.g., passive activity or at-risk rules). Given that changes to IRS forms take time, the instructions to the current form should be modified to direct taxpayers to provide such reconciliation information as an attachment to their return. At the very least, the IRS must provide timely and detailed guidance to taxpayers and their tax preparers concerning this matter before the 2003 filing season begins. In any case, new information requested from taxpayer to facilitate computer matching must be compatible with electronically filed returns and be accessible to IRS personnel responsible for the matching program.

A second issue of concern is the amount of personnel time required to perform this matching initiative. I originally anticipated that the Schedule K-1 matching initiative would be based on computer resources like the programs that match Form W-2s and Form 1099s, thereby allow the agency to use its personnel resources more efficiently. While I understand why such personnel have been dedicated to the Schedule K-1 matching project, I urge you to conduct a

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complete cost-benefit analysis to determine if such personnel resources could be better spent on compliance initiatives that cannot be achieved electronically. In addition, I would appreciate receiving a copy of any such analysis.

Lastly, I am concerned that the IRS is not classifying the Schedule K-1 matching initiative as an audit. From the perspective of a taxpayer who receives a notice stating that the IRS' records indicate that he owes additional tax (unless the taxpayer can prove to the contrary), the notice has all the trapping of an audit. It is difficult to differentiate this case from the situation in which an IRS agent contacts a taxpayer and asks the taxpayer to verify certain income or substantiate particular itemized deductions.

In addition, taxpayers who receive a Schedule K-1 matching notice will certainly be alarmed if they later receive a notice that the same return is being "audited" for issues not related to the Schedule K-1. At a time when the agency has received considerable attention for the falling "audit rate," I urge you to reevaluate the classification of this and other matching efforts under the Automated UnderReporter program. Taxpayers perceive that they are being audited by the agency in these instances, and the agency would clearly benefit from taxpayers understanding that the IRS examines tax returns in many ways – from matching to face-to-face audits. Such knowledge would clearly have value as a deterrence to those who would evade their obligations under the tax laws.

In the end, as you move forward with the Schedule K-1 matching initiative, I urge you to go deliberately and cautiously. Moreover, given the importance of the Schedule K-1 matching initiative to the small business community, I would appreciate your keeping me informed of your progress with this project and evaluation of its results.

Again, thank you for your assistance with this matter. If you have any questions or would like to discuss this matter in greater detail, please do not hesitate to contact me or have your staff contact Mark Warren, my Tax Counsel on the Committee on Small Business and Entrepreneurship, at 202/224-4086.

Sincerely,

A handwritten signature in black ink, appearing to read "Chris Bond", written in a cursive style.

Christopher S. Bond
Ranking Member